

Memorandum

Date: November 12, 1985

To: Water Utilities Branch
Technical Staff

From: **Public Utilities Commission—San Francisco -** Wes Franklin, Chief
Water Utilities Branch

File No:

Subject: Speculation in Class D Water Companies

Attached is the Commission's latest policy on the sale and transfer of Class D Water Companies. In the future, staff processing sale and transfer application for the Class D will be guided by Resolution W-3285. The most critical element of the new policy is the burden on the respective buyer to prove the financial soundness of the proposed acquisition, especially when buying well above book cost. This policy was intended to address those sales where the Commission will still have the responsibility of regulation after the sale, i.e., sales to individuals versus sales to public entities. As with any policy, this one should be applied with good judgment and adapted to meet the particular case at hand.

Attachment

Memorandum

Date: October 11, 1985

To: The Commission
(For the Meeting of October 17, 1985)

From: **Public Utilities Commission—San Francisco -** Wesley Franklin, Chief-Water Utilities Branch
M.J. Purcell, Policy & Planning Division

File No:

Subject: Speculation in Class D Water Companies

Recommendation: That the Commission issue the attached resolution which would require private parties to justify their intention to pay prices significantly in excess of net book value for purchase of small Class D water companies. By meeting criteria specified in the resolution, applicants would have to demonstrate that the proposed transactions are financially sound. Commission approval would not be authorized for uneconomic sales, that is, sales which are not likely to provide a return from rates on the buyer's investment. Commission approval would also be withheld for sales agreements whereby the buyer would finance the acquisition through the use of long-term debt which would place the company in a high leveraged position. It is intended that this resolution would deter speculation in the purchase and sale of Class D water companies, which in turn would lead to more responsible company management.

Background: The effects of speculation in small water company service will be the focus in this memorandum in two contexts: (1) the problems caused when some Class D owners refuse either to provide minimally acceptable water service or to divest their companies at a reasonable price to willing buyers, and (2) the problems caused when inexperienced parties buy Class D water companies at prices set considerably above depreciated rate base, leaving little or no opportunity for the buyers to earn a reasonable return on their investment. These two problems are sometimes related, as an owner who has overpaid for a water company may be reluctant to sell at a price below the acquisition cost.

The problems with the exploitive owner often go on for years. Given enough angry customers who are sufficiently organized, they may form a district or petition a local political subdivision to acquire the utility. In some cases, the public agency pays the owner's asking price and then the costs to make lengthy improvements necessary due to the deterioration of the system. If the customers are insufficiently organized to accomplish a buy out but complain to the Commission, the Commission may enter into extensive litigation trying to get the owner to effectively manage the system or to divest trying to get the owner to efficiently manage the system or to divest trying to get the owner to effectively manage the system or to divest ownership. With very stubborn owners this strategy may have virtually no effect at all. Or the owners may make some minimal improvement to avoid hearings and to justify additional, capital-related rate increases. In extreme cases, owners have abandoned their systems when the customers stopped paying their bills, due to the poor service, or their systems collapsed, failing to provide water.

When the Commission becomes familiar with these problems it is placed in a reactive position often with few options for a quick or effective fix for the future. This is not to say, however, that rigorous and creative regulation at this point isn't effective in mitigating the problems as evidenced in many cases. In one case, D.83-05-018, the Commission gave an owner 90 days to sell his system to a nearby public district before the Commission would file an action in Superior Court to place a receiver in control of his system. The price he would accept suddenly coincided with net book and he promptly sold. In another case, W-2392 (Meadowbrook Water Company, Inc.), the Commission made an entire rate increase subject to refund in the event the owner failed to make very basic and necessary improvements. Instead of making the improvements the owner pocketed the revenues (just after the customers paid their annual flat rate charge for the coming year) and illegally sold the system at a cocktail party to a friend. The Commission tried negotiation as well as years of hearings to get the system away from the illegal owner (who couldn't manage the system) and to a nearby district. But the bottom line was finally reached when the customers failed to pay their annual charge for the next year (after the Commission had ordered the refund). The illegal owner couldn't subsidize the system and he gave it up.

In another case, a Commissioner personally held hearings almost weekly in Dunsmuir one summer in order to fine the absentee owner of Shasta Retreat Water System (who lived in San Francisco and had to drive up for the hearings) who finally gave in to the regulatory pressure, and sold out to an adjacent company (D.89867). Desertification, i.e., revocation of a utility's authority to operate, as a solution for a poorly managed company, was considered in a current case (San Martin Water Company).

Unfortunately, these options are not available in all situations and, even if they are, it can take an inordinately long time and a considerable drain on Commission resources to effect the ownership change. And, most importantly, a substitution of owners doesn't repay the customers for the poor service they have received.

As a matter of jurisdictional prerogatives, regulation by the Commission and health departments should be designed to prevent this abuse of ratepayers. In exchange for the right of providing monopoly service, water utilities should be licensed regularly and either be penalized or disenfranchised for providing poor service. At present, however, the Commission does not have a program designed to avert the abuse of ratepayers and thus the examples cited above have tended to be reactive, ad hoc solutions applied when customers complain.

At the other extreme, we have also seen inexperienced parties agreeing to pay highly inflated prices for Class D water systems. Often these individuals have limited financial resources aside from the water company. It is not always clear why these transactions take place. Often these sales are made to retirement age individuals who visualize a good income opportunity. Or they believe, naively, that they can improve the systems with little capital and sell them at huge profits. They may anticipate growth in the number of customers which will result in increased revenues (eventually providing a return on the investment). Unfortunately, the Commission has had ample experience with the drawbacks to these sales. If the companies are in poor physical condition and service is inadequate, thereby requiring-extensive maintenance and/or capital improvements the new owners are sometimes unwilling and often unable to respond allowing service to deteriorate further.

Buyers are often willing to pay inflated prices for water companies because they believe they can do much of the maintenance and service themselves for the companies, such as the bookkeeping or repair of mains, and pocket ratemaking allowances for these expenses, thereby increasing their return. However, this may not work if for some reason the operator does have to hire help, thereby losing the allowances.

Although there are exceptions, it is generally the Commission's position neither to interfere with nor to disallow the transaction due to the level of the requested price. If the buyers contact the Commission staff, they are warned about any drawbacks to the sale and provided an informal education on the responsibilities of running a utility. On the application form the buyer must acknowledge that rates may be fixed only on depreciated rate base, of the buyer's cost of acquisition.

The majority of applications are approved on an ex-parte basis with minimal staff analysis. The analysis that is performed determines if the buyer has any assets, but no investigation as to the true value of the assets is made. In three cases in which there was serious question about the viability of proposed sales the applications did go to hearing. Staff cross-examined the parties and testified on the problems with the proposed sales. Although the problems varied in each of these cases, they all involved highly inflated sale prices. In two of the cases, the applications were denied and, in the opinion of staff, much more desirable outcomes have been accomplished. In one of these two cases, a new buyer who is a retired school administrator has bought the system at book value.

A brief description of the second case, D.82-05-011, involving the proposed sale of Descano Park Water Company to Sweet Water Works, Inc. is highlighted here. It is a classic example of speculation and shows the extensive efforts made by staff and the customers to prevent the transfer.

The requested transfer price was \$324,070, representing an amount three times the depreciated ratebase of the system, (approximately \$100,000). The application was forthright in presenting the view of the buyers that they could not derive an adequate income from the water company (in spite of their requesting that the rate base be increased to correspond to the proposed sale price). So they planned to develop a bottled water business at the water company site.

Not enjoying an abundant amount of water themselves, the alarmed customers initiated the paperwork to form a county water district. This was important due to the Commission's policy to prefer mergers of small companies with larger companies or their assumption by public agencies if service would be improved. Staff testimony to deny the proposed sale included the concern that the buyers had no definite plans for operation of the water company and that long-term debt to finance the sale would be greater than 50% of depreciated ratebase. The application was denied. This company continues to be operated by the owner and the final steps for transfer of the system to the county are in place. The adoption of the staff recommendation on leveraging should be applied on an industry wide basis and should discourage the practice of an applicant paying a small amount down and agreeing to carry a burdensome note. "Junk bond acquisitions" carry their own disadvantages and should not be encouraged.

Analysis:

At the present time, there appears to be a presumption with the Commission that most proposed transfers are desirable. Staff, therefore, is placed in a defensive position and has the burden of proof to demonstrate that a sale might not be in the public interest. This is disadvantageous for many reasons and constitutes an unwise resource drain for the Commission. The applicants are in the best

position to provide information on the viability and rationale for the sale. They should be required to do so. In the typical permit process the applicant must convince the permitting authority of the need for and likely success of the business venture. That procedure should be followed in these cases.

The purpose of this memo and resolution is not to preclude sales of water companies per se but to suggest guidelines for Commission use in the evaluation of proposed sales between private parties which appear speculative. It is also hoped that owners holding out for unreasonably inflated prices will have an incentive to reconsider their position. Approvals of transfers would be denied only if the terms of the transfer are so financially unsound that the transfer is likely to adversely affect the buyer's financial position and/or the management of the system to the detriment of ratepayers. Staff strongly believes that this would be an appropriate strategy for the Commission inasmuch as its power to approve sales extends to the right, indeed the responsibility, to disapprove sales which are not in the interest of the ratepayers. The standard used in evaluating proposed water company sales at inflated prices (i.e., at a price considerably above net book) should be similar to the standards used in the evaluation of a certificate or license application, which is granted after certain criteria are met, e.g., improving the financial integrity of the system or meeting cost-effectiveness. Staff does not recommend that the Commission set an upper limit on the amount over depreciated rate base which it would consider appropriate. The financial circumstances vary so greatly among utilities that setting an arbitrary limit would be counter productive. For example, a sale price of \$15,000 for a system with a net book value of \$10,000 might not be burdensome. A sale price of \$300,000 for a problematic system having a net book value of \$200,000, however, might present severe problems if approved.

An inflated price suggests that the market value of the system is not reflected in the system's depreciated historical cost. And the increment of price above that level does not inherently mean the price is imprudent. However, the Commission should actively investigate issues related to above-book pricing. Although there may be many non-financial rewards to running a small water company, which increase its market value, such as experimentation by a retiree etc., staff believes that due to the economic pressures on small water companies tested for reasonableness based upon a measure of the present or future return likely to be provided to the new owner.

This raises the issue of the criteria which may be used to ascertain whether an inflated value of a water company is realistic. The system's new income, both recorded and future, should be determined through an analysis of prior financial history and future operation projections. If the buyer believes that there will be growth (or some other circumstance) occurring which will increase the company's income, then substantial evidence should be provided to determine its reasonableness. For example, to ascertain whether there will be customer growth, the buyer should provide developers' requests for service, applications for or imminent zoning changes or indications that municipal services are being added to accommodate future growth. These matters may still be speculative in nature, but they at least explain the buyer's motivation in valuing the system. Along with evidence of projected growth, the buyer should be required to project utility costs to serve this new development and likely revenues deriving from the growth, to demonstrate that the water company sale price is appropriate if the development does occur.

If it appears that the inflated price does equate with the value of the system, as demonstrated by the evidence provided by the buyer and seller, then the Commission should approve the sale (implying there are no other controversies). Staff believes this policy will encourage more responsible and

economic pricing in Class D water company sales. This should reduce prices generally and incentives for speculation specifically. This should improve the Commission's ability to pressure undesirable owners to divest.

Water companies are sold at depreciated historical cost, both to individuals and other utilities, so apparently there is some incentive for such sales. In fact, companies are sold for \$1 in exchange for a release from the obligation of utility service, particularly if the present buyer foresees nothing but deterioration in the system and does not desire to commit capital or other energy to make improvements or foresees Commission action if there isn't improvement in the management of the system. It may be of note to mention here that large water companies rarely pay amounts over net book when acquiring systems. An exception to this was the recent purchase of the Westlake Water Company by California Water Service Company, Inc. for an inflated price. However, this has been justified by the fast customer growth in the system, evidenced by a later rate reduction.

In summary, as a matter of its regulation of small water companies, the Commission should more intensively and actively scrutinize sales transactions involving these companies. A policy requiring the demonstration that such sales are financially sound would discourage investor speculation in these companies and should place ratepayers in a position to obtain better service.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Copy for:

**Orig. and Copy
to Executive Director**

RESOLUTION NO. W-3285

**POLICY AND PLANNING
DIVISION**

RESOLUTION

_____**Director**
_____**Numerical File**
_____**Alphabetical File**
_____**Accounting Officer**

Date: October 17, 1985

SUBJECT: Resolution for Commission Adoption on Small (Class D) Water Company Sales Policy. This will be Applicable when the Proposed Sale Price is Set Above Depreciated Historical Cost.

WHEREAS: The Commission finds that Class D water companies are often sold at prices substantially in excess of depreciated historical cost due to investor speculation. When an owner cannot realize a profit through rates on the investment, this often results in deteriorating management of the system which affects ratepayers. For this reason, the Commission does not intend to approve water company sales at prices substantially above depreciated premium price. The affirmative burden of providing this evidence is on parties to the transaction. If the Commission is not assured of the financial soundness of the proposed sale, the sale will not be approved, without prejudice. The Commission also no longer intends to approve a sale involving the buyer's issuance of debt which places the company in a highly leveraged position.

The following criteria, among others, should be used to evaluate the potential for future revenues and net income derived from the utility operation that would justify payment in excess of its book value:

- A. Provisions of recorded and estimated financial data and results of operations.
- B. A five-year plan for operation of the system including projected system improvements, maintenance schedules and financing.
- C. Provision of an audit to verify the buyer's assets.

- D. Evidence of projected customer growth, including but not limited to: zoning, demands for service by developers, plans for municipal services to accommodate growth, costs of service by the utility to provide service to the projected growth, extent of likely growth and likely revenues derived from this growth.

Executive Director of the
Public Utilities Commission
of the State of California